

## CHAPTER 2

### THE GLOBAL ECONOMIC ENVIRONMENT

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#### SUMMARY

- A. The economic environment is a major determinant of global market potential and opportunity. In today's global economy, capital movements are the driving force, production is uncoupled from employment, and capitalism has vanquished communism. Based on patterns of resource allocation and ownership, the world's economies can be categorized as **market capitalism, centrally-planned capitalism, centrally-planned socialism, and market socialism**. The final years of the twentieth century were marked by transitions toward market capitalism in many countries that had been centrally controlled. However, great disparity still exists among the nations of the world in terms of economic freedom.
- B. Countries can be categorized in terms of their stage of economic development: **low income, lower middle income, upper middle income, and high income**. **Gross domestic product (GDP) and gross national income (GNI)** are commonly used measures of economic development. The 50 poorest countries in the low-income category are sometimes referred to as **least-developed countries (LDCs)**. Upper middle-income countries with high growth are often called **newly industrializing economies (NIEs)**. Several of the world's economies are notable for their fast growth; the **BRIC** nations include Brazil, Russia, India, and China. The **Group of Seven (G7), Group of Eight (G-8), and Organization for Economic Cooperation and Development (OECD)** represent efforts by high-income nations to promote democratic ideals and free-market policies throughout the rest of the world. Most of the world's income is located in the **Triad**, which is comprised of Japan, the United States, and Western Europe. Companies with global aspirations generally have operations in all three areas. Market potential for a product can be evaluated by determining **product saturation levels** in light of income levels.
- C. A country's **balance of payments** is a record of its economic transactions with the rest of the world; this record shows whether a country has a **trade surplus** (value of exports exceeds value of imports) or a **trade deficit** (value of imports exceeds value of exports). Trade figures can be further divided into **merchandise trade** and **services trade** accounts; a country can run a surplus in both accounts, a deficit in both accounts, or a combination of the two. The U.S. merchandise trade deficit was \$819 billion in 2007. However, the U.S. enjoys an annual service trade surplus. Overall, however, the United States is a debtor; China enjoys an overall trade surplus and serves as a creditor nation.
- D. Foreign exchange provides a means for settling accounts across borders. The dynamics of international finance can have a significant impact on a nation's economy as well as the fortunes of individual companies. Currencies can be subject to **devaluation** or

**revaluation** as a result of actions taken by a country's central banker. Currency trading by international speculators can also lead to devaluation. When a country's economy is strong or when demand for its goods is high, its currency tends to appreciate in value. When currency values fluctuate, global firms face various types of economic exposure. Firms can manage exchange rate exposure by **hedging**.

## **LEARNING OBJECTIVES**

- 1** Identify and briefly explain the major changes in the world economy that have occurred during the past few decades
- 2** Compare and contrast the main types of economic systems that are found in different regions of the world
- 3** Explain the categories of economic development used by the World Bank and identify the key emerging country markets at each stage of development
- 4** Discuss the significance of balance of payments statistics for the world's major economies
- 5** Identify the countries that are the world's leading exporters
- 6** Briefly explain how exchange rates impact a company's opportunities in different parts of the world

## **DISCUSSION QUESTIONS**

1. Explain the difference between market capitalism, centrally planned capitalism, centrally planned socialism, and market socialism. Give an example of a country that illustrates each type of system.

*Market capitalism* is an economic system in which individuals and firms allocate resources and production resources are privately owned. Consumers decide what goods they desire and firms determine what and how much to produce; the role of the state in market capitalism is to promote competition. Market capitalism is found in the United States.

*Centrally-planned capitalism* is an economic system in which command resource allocation is utilized extensively in an environment of private resource ownership. Centrally-planned capitalism is found in Sweden, where two-thirds of all expenditures are controlled by the government.

*Centrally-planned socialism* is an economic system in which the state has broad powers to serve the public interest as it sees fit. State planners make "top-down" decisions about what goods and services are produced and in what quantities; consumers can spend their

money on what is available. The government owns industries as well as individual enterprises. Centrally-planned socialism was found in the former Soviet Union.

*Market socialism* is an economic system in which market allocation policies are permitted within an overall environment of state ownership. Market socialism is found in China where farmers can offer part of their production in a free market.

2. The seven criteria for describing a nation's economy introduced at the beginning of this chapter can be combined in a number of different ways. For example, the United States can be characterized as follows:

- Type of economy: Advanced industrial state
- Type of government: Democracy with a multi-party system
- Trade and capital flows: Incomplete free trade and part of trading bloc
- The commanding heights: Mix of state and private ownership
- Services provided by the state and funded through taxes: Pensions and education but not health care
- Institutions: Transparency, standards, corruption is absent, a free press and strong courts
- Markets: Free market system characterized by high risk/high reward entrepreneurial dynamism

Use the seven criteria found on pp. 42-43 to develop a profile of one of the BRIC nations, or any other country that interests you. What implications does this profile have for marketing opportunities in the country?

Student answers will vary by country chosen.

3. Why are Brazil, Russia, India, and China (BRIC) highlighted in this chapter? Identify the current stage of economic development for each BRIC nation.

Experts predict that the BRIC nations will be key players in global trade even as their track records on human rights, environmental protections and other issues come under closer scrutiny by their trading partners.

India is in the Low-Income category. China and Brazil fall within the Lower-Middle-Income category. Russia is the only BRIC nation to be in the Upper-Middle-Income category.

4. Turn to the Index of Economic Freedom (Table 2-3) and identify where the BRIC nations are ranked. What does the result tell you in terms of the relevance of the index to global marketers?

All four BRIC countries fall within the "Mostly Unfree" category. This indicates that, while the index and what it stands for are certainly important to marketers, they are not willing to forego the business opportunities presented by these countries.

5. The Heritage Foundation's Index of Economic Freedom is not the only ranking that assesses countries in terms of successful economic policies. For example, the World Economic Forum (WEF; [www.weforum.org](http://www.weforum.org)) publishes an annual Global Competitiveness Report; in the 2010-2011 report, the United States ranks in sixth place according to the WEF's metrics. By contrast, Sweden is in third place. According to the Index of Economic Freedom's rankings the United States and Sweden are in sixth and twenty-sixth place, respectively. Why are the rankings so different? What criteria does each index consider?

The Heritage foundation measures trade policy, taxation policy, government consumption of economic output, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulations, and the black market. It does take a very conventional and conservative approach to classifying economies.

On the other hand, the World Economic Forum, according to their website, states: "*The World Economic Forum is an independent, international organization incorporated as a Swiss not-for-profit foundation. We are striving towards a world-class corporate governance system where values are as important a basis as rules. Our motto is 'entrepreneurship in the global public interest'. We believe that economic progress without social development is not sustainable, while social development without economic progress is not feasible. Our vision for the World Economic Forum is threefold. It aims to be: the foremost organization which builds and energizes leading global communities; the creative force shaping global, regional and industry strategies; the catalyst of choice for its communities when undertaking global initiatives to improve the state the world*"

<http://www.weforum.org/en/about/Our%20Organization/index.htm>.

Clearly, the WEF assigns a great deal of value to measuring the values and social developments, and opportunities of a country. This strong belief system influences the WEF's country ranking – not by what it currently possesses but by what it *should* be doing.

6. When the first edition of this textbook was published in 1996, the World Bank defined "low-income country" as one with per capita income of less than \$501. In 2003, when the third edition of *Global Marketing* appeared, "low income" was defined as \$785 or less in per capita income. As shown in Table 2-4 of this chapter, \$995 is the current "low income" threshold. The other stages of development have been revised in a similar manner. How do you explain the upward trend in the definition of income categories during the past 15 years?

The economic systems of countries are constantly developing and changes happen rapidly. The percentage of the world's GNI for low-income countries is now at a record low of 3.23 percent as compared to the lower-middle-income countries, and the upper-middle-income countries. This suggests great gains in income per person and income distribution for those living in the low-income countries. As countries in the low-income category begin to tackle their economic, social, and political problems, more opportunities present themselves for the people living in those countries.

7. A manufacturer of satellite dishes is assessing the world market potential for his products. He asks you if he should consider developing countries as potential markets. How would you advise him?

Developing markets should prove attractive on the basis of current low product saturation levels. High rates of growth in many developing countries suggest that some segments of the population save enough money to afford expensive electronics equipment such as a satellite dish. A satellite entrepreneur might invite neighbors to his home and charge them for the privilege of watching programming that would not otherwise be available. These neighbors might not be able to afford a satellite and related equipment, but they could afford to watch an occasional movie.

8. A friend is distressed to learn that America's merchandise trade deficit hit a record \$646 billion in 2010. You want to cheer your friend up by demonstrating that the trade picture is not as bleak as it sounds. What do you say?

The overall trade balance reflects merchandise as well as services trade as reported in official balance of payments figures. The U.S. typically runs a trade surplus in services, which serves to offset the merchandise trade deficit.

The United States is a major service trader. As shown in Figure 2-5, U.S. services exports in 2006 totaled approximately \$424 billion. This represented slightly less than one-third of total U.S. exports. The U.S. services surplus stood at \$80 billion. This surplus partially offset the U.S. merchandise trade deficit, which reached a record \$838 billion in 2006.

## **OVERVIEW**

This chapter will identify the most salient characteristics of the world economic environment, starting with an overview of the world economy. We then present a survey of economic system types, a discussion of the stages of market development, and an explanation of balance of payments. Foreign exchange is discussed in the final section of the chapter. Throughout the chapter, we will discuss the implications of the worldwide economic downturn on global marketing strategies.

## **ANNOTATED LECTURE/OUTLINE**

### **THE WORLD ECONOMY—AN OVERVIEW**

The world economy has changed dramatically since World War II. Perhaps the most fundamental change is the emergence of global markets; responding to new opportunities, global competitors have displaced or absorbed local ones.

The integration of the world economy has increased significantly. Economic integration was 10 percent at the beginning of the 20th century; today, it is approximately 50 percent.

During the past two decades, the world economic environment has become increasingly dynamic; change has been dramatic and far-reaching. To achieve success, executives and marketers must take into account the following new realities:

✓ **(Learning Objective #1)**

- a) Capital movements have replaced trade as the driving force of the world economy.
- b) Productivity has become “uncoupled” from employment.
- c) The world economy dominates the scene; individual country economies play a subordinate role.
- d) The struggle between capitalism and socialism that began in 1917 is over.
- e) The growth of e-commerce diminishes the importance of national barriers and forces companies to reevaluate their business models.

The first change is the increased volume of capital movements. The dollar value of trade in goods and services was \$25 trillion in 2009. However, the Bank for International Settlements has calculated that foreign exchange transactions worth approximately \$4 trillion are booked *every day*. This works out to more than \$1 quadrillion annually, a figure that far surpasses the dollar value of world trade in goods and services. An inescapable conclusion resides in these data: Global capital movements far exceed the dollar volume of global trade. In other words, *currency trading represents the world’s largest market*.

The second change concerns the relationship between productivity and employment. To illustrate this relationship, it is necessary to review some basic macroeconomics. **Gross domestic product (GDP)**, a measure of a nation’s economic activity, is calculated by adding consumer spending (*C*), investment spending (*I*), government purchases (*G*), and net exports (*NX*):

$$C + I + G + NX = \text{GDP}$$

**Emerging Markets Briefing Book: It Time to Take the “R” out of BRIC? Russia’s Economic Roller-Coaster Ride**

Despite the positive publicity, however, the phrases *managed democracy* and *state capitalism* can be used to describe the arbitrary exercise of state power in Russia. Russia plans to limit foreign investment in strategic industries such as oil; the term *renationalization* has been applied to the process by which state-owned enterprises are acquiring rivals. There are other problems as well. Russia’s entrenched bureaucracy is a barrier to increased economic freedom. The banking system remains fragile and is in need of reform.

Economic growth, as measured by GDP, reflects increases in a nation's productivity. Until the recent economic crisis, employment in manufacturing had remained steady or declined while productivity continued to grow.

Now, employment rates have declined in countries where a bubble economy of misallocated resources in housing and real estate has collapsed. In the United States, manufacturing's share of GDP declined from 19.2 percent in 1989 to 13 percent in 2009.

In 2011, manufacturing employment accounted for about 9 percent of the U.S. workforce; in 1971, the figure was 26 percent. During that 40-year period, productivity has increased dramatically. Similar trends can be found in many other major industrial economies as well.

Manufacturing is not in decline—it is *employment* in manufacturing that is in decline.

Creating new jobs is one of the most important tasks facing policymakers today.

The third major change is the emergence of the world economy as the dominant economic unit. Company executives and national leaders who recognize this have the greatest chance of success.

This change has brought two questions to the fore: How does the global economy work, and who is in charge? Unfortunately, the answers to these questions are not clear-cut.

The fourth change is the end of the Cold War. The demise of communism as an economic and political system can be explained in a straightforward manner: Communism is not an effective economic system. The overwhelmingly superior performance of the world's market economies has given leaders in socialist countries little choice but to renounce their ideology.

A key policy change in such countries has been the abandonment of futile attempts to manage national economies with a single central plan. This policy change frequently goes hand in hand with governmental efforts to foster increased public participation in matters of state by introducing democratic reforms.

Finally, the personal computer revolution and the advent of the Internet era have in some ways diminished the importance of national boundaries.

## **ECONOMIC SYSTEMS**

### **✓ (Learning Objective #2)**

Traditionally, there are four main types of economic systems: market capitalism, centrally planned socialism, centrally planned capitalism, and market socialism. This classification was based on the dominant method of resource allocation (market versus command) and the dominant form of resource ownership (private versus state) (see Figure 2-1).

Alternatively, more robust descriptive criteria include the following:

- Type of economy

- Type of government
- Trade and capital flows
- The commanding heights
- Services provided by the state and funded through taxes
- Markets

## **Market Capitalism**

**Market capitalism** is an economic system in which individuals and firms allocate resources, and production resources are privately owned. Consumers decide what goods they desire, and firms decide how much to produce; the state's role is to promote competition (see Table 2 -1).

It would be a gross oversimplification to assume that all market-orientated economies function in an identical manner.

## **Centrally-Planned Socialism**

At the opposite end of the spectrum is **Centrally-planned socialism**. Centrally-planned socialism gives the state broad powers to serve the public as it sees fit.

State planners make “top-down” decisions about the goods and services produced and in what quantities; consumers spend money on what is available.

Government ownership of industries and individual enterprises is characteristic. Demand exceeds supply, and there is little reliance on product differentiation, advertising, or promotion. To eliminate “exploitation” by intermediaries, the government controls distribution.

Because of market capitalism's superiority, many socialist countries have adopted it; the ideology developed by Marx and perpetuated by Lenin has been resoundingly refuted.

For decades, the economies of China, the former Soviet Union, and India functioned according to the tenets of centrally planned socialism. All three countries are now engaged in economic reforms characterized, in varying proportions, by increased reliance on market allocation and private ownership.

## **Centrally-Planned Capitalism and Market Socialism**

In reality, market capitalism and centrally-planned socialism do not exist in “pure” form. Command and market resource allocation are practiced simultaneously, as are private and state resource ownership. The role of government in modern market economies varies widely.

**Centrally-planned capitalism** is an economic system in which command resource allocation is used extensively in an environment of private resource ownership (e.g., Sweden).

**Market socialism** permits market allocation policies within an overall environment of state ownership.

Market reforms and nascent capitalism in many parts of the world are creating opportunities for large-scale investments by global companies.

The Heritage Foundation, a conservative think tank, classifies economies according to the degree of economic freedom enjoyed. The variables considered in compiling the rankings include:

- trade policy
- taxation policy
- government consumption of economic output
- monetary policy
- capital flows
- foreign investment
- banking policy
- wage and price controls
- property rights
- regulations
- the black market

The rankings form a continuum from “free” to “repressed.” Hong Kong and Singapore are ranked first and second in terms of economic freedom; Cuba, Laos, and North Korea are ranked lowest (see Table 2-3).

A high correlation exists between the degree of economic freedom and the extent to which a nation’s mixed economy is heavily market orientated.

#### **The Cultural Context: When Oliver Met Hugo**

Covers how the country of Venezuela economy works under Chavez – the disparity between what the government claims versus how the people of Venezuela live.

## **STAGES OF ECONOMIC DEVELOPMENT**

✓ **(Learning Objective #3)**

At any point in time, individual country markets are at different stages of economic development.

The World Bank has developed a four-category classification system that uses per capita **gross national income (GNI)** as a base. Although the income definition for each of the stages is arbitrary, countries within a given category generally have a number of characteristics in common. (Table 2-4).

Today, global attention is focused on opportunities in Brazil, Russia, India and China (collectively known as BRIC). For each of the stages of economic development, special attention is given to the BRIC countries.

***Low-Income Countries***

Low-income countries have a **GNI per capita of less than \$936**. The general characteristics shared by countries at this income level are:

- limited industrialization and a high percentage of the population engaged in agriculture and subsistence farming
- high birth rates
- low literacy rates
- heavy reliance on foreign aid
- political instability and unrest
- concentration in Africa south of the Sahara

Approximately 13 percent of the world's population is included in this group. Typically, these countries provided limited investment opportunities.

However, there are exceptions; for example, in Bangladesh, where per capita GNP is approximately \$590, the garment industry has enjoyed burgeoning exports.

The newly independent countries of the former Soviet Union present an interesting situation: Income is declining, and there is considerable economic hardship. The potential for disruption is, therefore, high.

***Lower-Middle-Income Countries***

The United Nations designates fifty countries in the bottom ranks of the low-income category as **least-developed countries (LDCs)**.

The term is sometimes used to indicate a contrast with **developing** (i.e., upper ranks of low-income plus lower-middle and upper-middle-income) **countries** and **developed** (high-income) **countries**.

Lower-middle-income countries are those with a GNI per capita between \$996 and \$3,945.

With a 2009 GNI per capita of \$1,180, India has transitioned out of the low-income category and now is classified as a lower-middle-income country.

Consumer markets in these countries are expanding rapidly. Countries such as China and Thailand represent an increasing competitive threat as they mobilize their relatively cheap labor forces to serve target markets in the rest of the world.

The developing countries in the lower-middle-income category have a major competitive advantage in mature, standardized, labor-intensive industries such as making toys and textiles.

China is the other BRIC nations in the lower-middle-income category. China represents the largest single destination for foreign investment in the developing world.

Despite ongoing market reforms, Chinese society does not have democratic foundations. Although China has joined the World Trade Organization, trading partners are still concerned about human rights, protection of intellectual property rights, and other issues.

### **Upper-Middle-Income Countries**

Upper-middle-income countries, *also known as industrializing or developing countries* are those with GNP per capita ranging from \$3,946 to \$12,195.

Brazil is the largest country in Latin America in terms of the size of its economy, population, and geographic territory.

Brazil also boasts the richest reserves of natural resources in the hemisphere; China, Brazil's top trading partner, has an insatiable appetite for iron ore and other commodities.

Government policies aimed at stabilizing Brazil's macroeconomy have yielded impressive results: Brazil's GNI has grown at an average annual rate of 4 percent over the past 8 years. During the same time period, nearly 50 million Brazilians have joined the middle class as incomes and living standards have risen.

Lower-middle- and upper-middle-income countries that achieve the highest sustained rates of economic growth are sometimes referred to collectively as **newly industrializing economies**.

Overall, NIEs are characterized by greater industrial output than developing economies; heavy manufactures and refined products make up an increasing proportion of exports. Goldman Sachs, the firm that developed the BRIC framework a decade ago, has identified a new country grouping called Next-11 (N11).

Five of the N11 countries are considered NIEs. These include three lower-middle-income countries: Egypt, Indonesia, and the Philippines. Mexico and Turkey are N11 NIEs from the ranks of the upper-middle income category.

### **Marketing Opportunities in LDCs and Developing Countries**

Despite many problems in LDCs and developing countries, it is possible to nurture long-term market opportunities.

Although Nike sells only a small portion of its output in China, it clearly has the future in mind when it refers to China as a “two-billion-foot market.”

Prahalad and Hammond have identified several assumptions and misconceptions about the “bottom of the pyramid” (BOP) that need to be corrected:

- *Mistaken assumption #1: The poor have no money.*

The aggregate buying power of poor communities can be substantial. In rural Bangladesh, for example, villagers spend considerable sums to use village phones operated by local entrepreneurs.

- *Mistaken assumption #2: The poor are too concerned with fulfilling basic needs to “waste” money on non-essential goods.*

Consumers who are too poor to purchase a house do buy “luxury” items such as television sets and gas stoves to improve their lives.

- *Mistaken assumption #3: The goods sold in developing markets are so inexpensive that there is no room for a new market entrant to make a profit.*

In reality, because the poor often pay higher prices for many goods, there is an opportunity for efficient competitors to realize attractive margins by offering quality and low prices.

- *Mistaken assumption #4: People in BOP markets cannot use advanced technology.*

Residents of rural areas can and do quickly learn to use cell phones, PCs, and similar devices.

- *Mistaken assumption #5: Global companies that target BOP markets will be criticized for exploiting the poor.*

The informal economies in many poor countries are highly exploitative. A global company offering basic goods and services that improve a country’s standard of living can earn a reasonable return while benefiting society.

One of marketing’s roles in developing countries is to focus resources on the task of creating and delivering products that are best suited to local needs and incomes.

Marketing can be the link that relates resources to opportunity and facilitates need satisfaction on the consumer’s terms.

Some believe marketing is relevant only in affluent, industrialized countries.

- The argument: In less-developed countries the major problem is the allocation of scarce resources toward obvious production needs. Efforts should focus on production and how to increase output, not on customer needs and wants.
- The converse argument: The role of marketing – to identify people’s needs and wants and to focus individual and organizational efforts to respond to these needs and wants – is the same in all countries, irrespective of level of economic development.

There is also an opportunity to help developing countries join the Internet economy. Global companies can also contribute to economic development by finding creative ways to preserve old-growth forests and other resources while creating economic opportunities for local inhabitants.

### **High-Income Countries**

These are advanced, developed, industrialized, or postindustrial countries, having a per capita GNP of \$12,196 or higher. They have reached their present income level through sustained economic growth.

The phrase “postindustrial countries” describes the United States, Sweden, Japan, and other advanced, high-income societies.

Product and market opportunities in a postindustrial society are heavily dependent upon new products and innovations.

Seven high-income countries—the United States, Japan, Germany, France, Britain, Canada, and Italy—comprise the **Group of Seven (G-7)**. Finance ministers, central bankers, and heads of state from the seven nations have worked together for more than a quarter of a century in an effort to steer the global economy in the direction of prosperity and to ensure monetary stability.

Representatives from OECD member nations work together in committees to review economic and social policies that affect world trade.

### **The Triad**

The ascendancy of the global economy has been noted by many observers in recent years. One of the most astute is Kenichi Ohmae, former chairman of McKinsey & Company Japan. In his book *Triad Power*, Ohmae argued that successful global companies had to be equally strong in the dominant economic centers of Japan, Western Europe, and the United States.

These three regions, called the **Triad**, represented the dominant centers of the world and the location of nearly 75 percent of world income, as measured by GNP.

The **expanded Triad** includes the entire Pacific region, Canada and Mexico; and the boundary in Europe is moving eastward.

## **BALANCE OF PAYMENTS**

### **✓ (Learning Objective #4)**

The balance of payments is a record of all economic transactions between the residents of a country and the world. It is divided into the current and capital accounts. (Table 2-5).

The current account is a measure that includes trade in merchandise and services, plus certain categories of financial transfers such as humanitarian aid.

A country with a negative current account balance has a trade deficit; that is, the outflow of money to pay for imports exceeds the inflows of money for sales of exports

A country with a positive current account balance has a trade surplus. The capital account is a record of all long-term direct investment, portfolio investment and other short- and long-term capital flows.

A country accumulates reserves when the net of its current and capital account transactions shows a surplus; it gives up reserves when the net shows a deficit.

A close examination of Table 2-5 reveals that the United States regularly posts deficits in both the current account and the trade balance in goods.

Overall, the U.S. post balance of payments deficits while important trading partners, such as China, have surpluses. (Table 2-6).

## **TRADE IN MERCHANDISE AND SERVICES**

Thanks in part to the achievements of GATT and the WTO, world merchandise trade has grown at a faster rate than world production since the end of World War II.

According to figures compiled by the World Trade Organization, the dollar value of world trade in 2009 totaled \$11.8 trillion.

### **✓ (Learning Objective #5)**

In 2003, Germany surpassed the United States as the world's top merchandise exporter. Exports generate 40 percent of Germany's gross domestic product, and 9 million jobs are export related.

In 2009, China leapfrogged Germany in the global merchandise export rankings (see Table 2-7).

China's top-place ranking underscores its role as an export powerhouse; the country has demonstrated continued economic strength by achieving double-digit export growth.

Chinese exports to the United States have surged since China joined the World Trade Organization in 2001; in fact, policymakers in Washington are pressuring Beijing to boost the value of the yuan in an effort to stem the tide of imports.

The fastest-growing sector of world trade is trade in services. Services include travel and entertainment; education; business services, such as accounting, advertising, engineering, investment banking, and legal services; and royalties and license fees that represent payments for intellectual property. One of the major issues in trade relations between the high- and lower-income countries is trade in services.

Table 2-8 provides a different perspective on global trade. The European Union is treated as a single entity with import and exports that exclude intra-regional trade among the 25 countries that were EU members at the end of 2006. It shows that the EU is the #1 exporter and importer of world merchandise in 2006.

The United States is a major service trader. As shown in Figure 2-2, U.S. services exports in 2010 totaled nearly \$550 billion. This represents about one-third of total U.S. exports. The U.S. services surplus (service exports minus imports) stood at \$145 billion. This surplus partially offset the U.S. merchandise trade deficit, which declined to \$646 billion in 2010 from a record \$838 billion in 2006. American Express, Walt Disney, IBM, Microsoft, and UPS are a few of the U.S. companies that have experienced rapid growth in demand for their services around the world.

## OVERVIEW OF INTERNATIONAL FINANCE

Foreign exchange makes it possible for a company in one country to conduct business in other countries with different currencies.

The foreign exchange market consists of a buyer's market and a seller's market where currencies are traded for both spot and future delivery on a continuous basis.

**Devaluation** can result from government action that mandates a reduction in the value of the local currency against other currencies.

To the extent that a country sells more goods and services abroad than it buys, there will be a greater demand for its currency and a tendency for it to appreciate in value—unless the government pursues foreign-exchange policies that do not allow the currency to fluctuate. In international economics, such policies are called *mercantilism* or *competitive-currency politics* because they favor domestic industries at the expense of foreign competitors.

### **The Big Mac Index**

One way to answer the question is to compare world prices for a single well-known product: McDonald's Big Mac hamburger. The so-called "Big Mac Index" is a 'quick and dirty' way of determining which of the world's currencies are too weak or strong.

The underlying assumption is that the price of a Big Mac in any world currency should, after being converted to dollars, equal the price of a Big Mac in the United States.

A country's currency would be overvalued if the Big Mac price (converted to \$) is higher than the U.S. price. Conversely, a country's currency would be undervalued if the converted Big Mac price is lower than the U.S. price.

### **Economic Exposure**

*Economic exposure* reflects the impact of currency fluctuations on a company's financial performance. Economic exposure can occur when a company's business transactions result in sales or purchases denominated in foreign currencies.

### **Managing Exchange Rate Exposure**

✓ (Learning Objective #6)

It should be clear from this discussion that accurately forecasting exchange rate movements is a major challenge. Forecasting exchange rate movements is a major challenge. Over the years, the search for ways of managing cash flows to eliminate or reduce exchange rate risks has resulted in the development of numerous techniques and financial strategies.

**Hedging** exchange rate exposure involves establishing an offsetting currency position such that the loss or gain of one currency position is offset by a corresponding gain or loss in some other currency.

External hedging methods for managing both transaction and translation exposure require companies to participate in the foreign currency market. Specific hedging tools include forward contracts and currency options.

*Internal hedging methods* include price adjustment clauses and intra-corporate borrowing or lending in foreign currencies.

The forward market is a mechanism for buying and selling currencies at a preset price for future delivery.

For a foreign currency, **option** is best for such situations. A **put option** gives the buyer the right, not the obligation, to sell a specified number of foreign currency units at a fixed price, up to the option's expiration date.

Conversely, a **call option** is the right, but not the obligation, to buy the foreign currency. In other words, the U.S. company locks in the value of the contract in dollars. Thus, if the project is granted, the future foreign currency cash inflow has been hedged by means of the put option. If the project is *not* granted, the company can trade the put option in the options market without exercising it; remember: options are rights, not obligations.

## **CASES**

### **Case 2 -1: A New Front in the Battle of Ideas**

Overview: The economic environment has changed since the economic crisis began in 2008. In one view, the G-7 world was characterized by widespread agreement that prosperity depended on the rule of law, independent courts, transparency, and a free media. In this world, free market capitalism is the dominant ideology and global corporations are the principle economic heavyweights. These global players seek to maximize profit and thereby increase shareholder wealth.

So, what has changed? China has emerged from the global economic crisis in relatively good shape, yet China's leaders do not fully embrace free market economics. The courts are not independent, and the media is not free. Moreover, China is not a democracy. Under state capitalism, politicians become key economic actors; rather than making profit the number one goal, they seek first to achieve political goals. China's success has emboldened socialist-leaning ruling elites in other countries to pursue economic growth while solidifying their own bases of political power. This is creating friction between competing economic systems.

1. Does the global economic crisis signal that the American model of free market capitalism is fundamentally flawed?

Not necessarily flawed, just bruised a little. The American model of capitalism does not fully address the different social situations of all of the countries around the world, which are: those that are centrally planned capitalism, centrally planned socialism, and market socialism. Each system requires different approaches to prevent and alleviate an economic crisis

2. Keynes and Hayek aren't necessarily household names, but they did get a boost when economist Russell Roberts created a rap video title *Fear the Boom and Bust* with filmmaker John Papola. The video is available on YouTube. After viewing it, you should be able to answer the following question. Are you a Keynesian? Or do you side with Hayek?

Student answers will vary.

3. Policymakers in Japan, the world's second-largest economy must transition their nation away from a manufacturing-dependent model for growth. What industry sectors might emerge as the new drivers of economic growth?

The service sector and environmental manufacturing and service opportunities abound for Japan as it transitions' from a manufacturer of goods to a producer of goods and services. One of the fastest-growing sectors of world trade is the trade of services between high income and low- or middle-income countries. Japan with its location in Asia stands to profit from their distribution of services to that continent.

4. Do you think that the economic stimulus programs in the United States, Asia, and elsewhere are the right approach to pulling the world out of recession?

The movement of capital, the production of goods, the balance of payment, trade surpluses, trade deficits, and service trades are all key driving forces surrounding a country's economy. The US balance of payment in both its current and capital accounts

are in the negative range. Therefore, it is unlikely that the US can further influence the world's economy.

5. The case mentions China, Russia, and Latin America as countries and regions where state capitalism is present. Are there state capitalist powers in other parts of the world?

A case can be made that countries that the Nordic model with such as Sweden, Denmark, and the social model economy model such as Germany exercise extensive state capitalism in their societies.

### **Case 2-2: Ecuador's Galapagos Islands and Ecotourism**

Overview: Ecuador boasts a dazzling mix of geographic wonders, including the Galapagos Islands. Today, tourists are a constant presence on the islands. Ecotourism has been behind Ecuador's economic growth during the past decade.

1. The case reports economic data showing the GDP in the Province of Galapagos increased 78 percent over the six-year period from 1999 to 2005. However, during the same period, per capita GDP showed an increase of less than 2 percent.

What is the explanation for this? What are the implications for sustainable development of the Galapagos tourism industry?

Tourism played an important role in the growth of the economy – accounting for about two-thirds percent of that growth. Obviously, the economic advantages of ecotourism is not being realized by the entire Galapagos population – growing only 2 percent while the actual number of the human population doubled to 30,000 in the past decade.

Sustainable development and growing tourism for the Galapagos Islands are mutually exclusive goals. With an increase in people comes damaging “footprints” – food, water, and sanitation that may require extensive ecological changes to the islands to accommodate. These numbers, only a slight gain in GDP by native Ecuadorians for example, shows that a massive increase in tourism would only damage the ecological environment and not substantially improve the lives of the Ecuadorians.

2. The Galapagos Islands are home to many different endemic species. Do you think that Ecuador's policymakers have done enough to ensure sustainable growth of the tourism sector? Are the limits on human inhabitants and visitors stringent enough? Too stringent?

Student answers will differ depending on their positions and values.

3. How do you market something such as the Galapagos Islands, which have such strict guidelines?

Marketing involves delivering a product or service that meets the needs and wants of your target market with a value proposition that is superior to your competitors. In the case of the Galapagos Islands, the “product” is the unspoiled nature and habitat of these

islands. Human interaction, in the form of tourism, can virtually destroy the very “product” they’ve come to experience.

Ecuadorians should not worry about controlling the “demand” side but rather the “supply” side by limiting exposure and using price as a limitation factor for Ecotourism.

### **Discussion Questions**

1. What are the prospects for sustainable development of the Galápagos tourism industry?

A strong case can be made for a positive prospect for a sustainable development for the Galapagos tourism industry. Conversely, one can make a similar strong case that where man goes he leaves his mark and, as such, affects the island’s ecosystem. Examples that Ecuador can use as a model would be the islands of Hawaii, Indonesia, and the Caribbean.

2. The Galápagos Islands are home to many different endemic species. Are the limits on human inhabitants and visitors stringent enough? Too stringent?

Student answers will vary – some will agree that these standards are too stringent ; others disagree.

3. How does one market something such as the Galápagos Islands which has such strict guidelines?

There is no “right” answer to this question. Obviously, the natural resource potential that the islands offer the country of Ecuador (tourism) must be carefully weighted with the destructive nature of man. As a country that can be / should be considered a lower- or middle-income country, Ecuador, has no option but to utilize all of its natural resources for the benefit of its people.

### **Case 2-3: Argentina Uncorks Malbec; World Ready for a Glass**

Overview: Argentina has been producing wine since the sixteenth century, but the country’s winemakers did not start competing globally until recently. Argentina’s sudden popularity in global markets is due in large part to Malbec, a grape variety that is now synonymous with Argentina. Argentina currently boasts 278 wineries with 1,047 labels, with the vast majority operating in the Mendoza region. Argentina is the fifth-largest wine-producing nation in the world. The target market for Argentina’s wine exports is the United States rather than Europe. As can be inferred from these examples, times are good in Mendoza, but threats in Argentina’s internal and external environments do exist. Perhaps the biggest threat is Argentina itself. Other regions are also starting to experiment with Malbec-based wines. Argentina and Malbec are synonymous for now, but that identity could be lost.

### **Discussion Questions**

1. Identify the marketing strategies that have helped Argentina's wine industry expand beyond its home market and reach consumers in all parts of the world.

Argentina's marketing strategies include: product differentiation (Malbec); Competitive pricing: value to the consumer (\$10.00 bottle of good wine); use of government protection; repositioning strategy in the global market and strong international investment.

2. Even though the Malbec grape is well known in Argentina, consumers in other countries are less familiar with it. What recommendations do you have to help increase consumer understanding of, and appreciation for, Malbec-based wines?

Product education is key; help the wine lover understand the benefits of the flavor of the grape via international marketing and educational events. Of course, any increase in the marketing budget from \$ 3 M is a help.

3. The forces of supply and demand affect many industries, and the wine industry is no exception. Currently the world is awash in an ocean of excess wine. Winemakers in France, Australia, and other countries are struggling financially. Given this situation, what can Argentina's wine producers do to maintain or increase their market share?

Increase emphasis on product differentiation and value for the money. Niche marketing – Argentina wines – is a key strategy to employ when the market is saturated with undifferentiated products/services.

## **TEACHING TOOLS AND EXERCISES**

### **Additional Cases**

"Cherries With Charm: Turkey's Alara Agri" by Michael R. Pearce and Jordan Mitchell, June 2009. *HBS*: 909A19-PDF-ENG.

"Pan Boricua: Developing a Market Strategy for the Hispanic Market in the United States" by Victor Quinones; Julia Sagebien; Marisol Perez-Savelli; Eva Perez; Jennifer Catinchi  
*HBS*: 909A20-PDF-ENG

"Global Wine War 2009: New World versus Old." Christopher A. Bartlett, *HBS*, 910405.

**Out-Of-Class Reading:** Assign the following seminal article on marketing and ask students to apply the concepts presented to global marketing.

Theodore Levitt, "Marketing Myopia," *Harvard Business Review* 80, no. 7/8 (July-August 2004), pp. 138-149.

**Internet Exercise:** Have students go to <http://finance.yahoo.com/currency?u>. This site offers a foreign exchange calculator that allows easy comparison of currency exchange rates. Students will select a few currencies such as the Thai baht, the Chinese yuan, the Malaysian ringgit, and Indonesian rupee and compare exchange rates.

**Activity:** Either in groups or individually, students should begin preparing their Cultural and Economic Analysis and Marketing Plan as noted in Chapter 1.

**Videos:** This video basically shows a PowerPoint presentation of what to consider when going global, as well as the factors, and how to enter different markets. At the end it gives some random facts, for example that more than half of the world's notebook computers are made under contract in Taiwan.

Link: <http://www.youtube.com/watch?v=t0OMYXYMAeI>

This video was produced by the Tuck School of Business at Dartmouth. He explains how people in the Western world, India for example, weigh more heavily on advertisement than people in America do. The presenter explains that cultural awareness and cultural knowledge are necessary prerequisites to be successful in a global market. At the end he gives advice to students including learning another language, and becoming informed of another culture, developing empathy, etc. These traits will help you open up more to managing a global business. 3 ½ minutes long.

Link: <http://www.youtube.com/watch?v=fbBMOjoMDA4&feature=relmfu>

**Film:** Have students watch the movie "Wall Street." Although not dealing directly with international finance, the film gives students insight into various financial dealings and transactions and the potential outcomes associated.

## **SUGGESTED READINGS**

### ***Books***

Enghold, Christopher. *Doing Business in Asia's Booming China Triangle*. Upper Saddle River, NJ: Prentice Hall, 1994.

Finger, Michael J. *Institutions and Trade Policy*. Northampton, MA: Edward Elgar, 2002.

Garten, Jeffrey E. *The Big Ten: The Big Emerging Markets and How They Will Change Our Lives*. New York: BasicBooks, 1997.

Isaak, Robert A. *Managing World Economic Change*. Upper Saddle River, NJ: Prentice Hall, Inc., 1995.

Kennedy, Paul. *The Rise and Fall of Great Powers*. New York: Random House, 1987.

- McCue, Sarah. *Force to Force: Building Profitable E-Commerce Strategies*. Mason, OH: Thomson Higher Education, 2006.
- Roberts, Paul C., and Karen Le Follette Araujo. *The Capitalist Revolution in Latin America*. Oxford: Oxford University Press, 1997.
- Shapiro, Alan C. *Multinational Financial Management*, 5th ed. Upper Saddle River, NJ: Prentice Hall, Inc., 1995.
- Porter, Michael E. *The Competitive Advantage of Nations*. New York: The Free Press, 1990.
- Thurow, Lester. *Head to Head: The Coming Economic Battle Among Japan, Europe, and America*. New York: William Morrow and Company, Inc., 1992.

### **Articles**

- Cavusgil, S. Tamer. "Measuring the Potential of Emerging Markets: An Indexing Approach." *Business Horizons* 40, no. 1 (January/February 1997), pp. 87-91.
- Czinkota, Michael R. "The World Trade Organization – Perspectives and Prospects," *Journal of International Marketing* 3, no. 1 (1995), pp. 85-92.
- Dowlah, C.A.F. "The Future of the Readymade Clothing Industry in the Post-Uruguay Round World." *World Economy* 22, no. 7 (September 1999), pp. 933-953.
- Golden, Peggy A., Patricia M. Doney, Denise M. Johnson, and Jerald R. Smith, "The Dynamics of a Marketing Orientation in Transition Economies: A Study of Russian Firms," *Journal of International Marketing* 3, no. 2 (1995), pp. 29-49.
- Kaikati, Jack G., George M. Sullivan, John M. Virgo, T. R. Carr, and Katherine S. Virgo, "The Price of International Business Morality: Twenty Years under the Foreign Corrupt Practices Act," *Journal of Business Ethics* 26, no. 3 (2000), pp. 213-222.
- Knight, Gary and S. Tamer Cavusgil. "Innovation, Organizational Capabilities and the Born Global Firm," *Journal of International Business Studies* 35, no. 2 (2004), pp. 121-141.
- Prowse, Michael. "Is America in Decline?" *Harvard Business Review* 70, no. 4 (July/August 1992), pp. 36-37.
- Swift, Time and Mudambi, Ram, "Leveraging Knowledge and Competencies Across Space: The Next Frontier in International Business" [Journal of International Management Volume 17, Issue 3](#), September 2011, Pages 186–189.
- Yan, Rick, "To Reach China's Consumers, Adapt to *Guo Qing*," *Harvard Business Review* 72, no. 5 (September/October 1994), pp. 66-74.